STATE LEVEL FISCAL REFORMS IN INDIA:
SOME CORE ISSUES

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Abstract

Almost all states in India have been reeling under severe fiscal crisis from the middle of the eighties. Despite efforts to contain them, these deficits in the states' budgets had been only increasing in the nineties after coming down during the first three years. The reasons for the widening budget deficits are obvious. There has been large increase in public expenditure unmatched by corresponding improvement in the mobilization of tax and non-tax revenue, particularly of the latter. This has led to the states resorting to the easier option of borrowing from all types of sources at increasingly usurious rates of interest. This has introduced instability in the budgets and has added to the burden of public debt.

The real reason for worrying about the widening budgetary gaps and the increasing debt burden lies in the low productivity of public expenditure financed by borrowings. The productivity of expenditure has been further affected by cuts based on the present accounting classifications of expenditure into revenue and capital, plan and non-plan, developmental and non-developmental etc. Public expenditure management calls for redefining the role of the state, reordering state's priorities and re-engineering of the government.

Resource mobilization, particularly from non-tax revenue sources calls for increased recovery of costs from the users of government services. At the same time, the governments should not go from the present extreme position of near total subsidisation to the other extreme of zero subsidization, without taking into account the externalities of most of the public services and equity considerations. Fiscal reforms also call for public sector reforms as the links between the budgets and the performance of the public sector are many.

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State Level Fiscal Reforms in India: Some Core Issues

All States in the Indian Union with the exception of a few Special Category States in the North East and the National Capital Territory of Delhi have been reeling under severe fiscal crisis for quite some time. The Damocles' sword of RBI suspending treasury payments is hanging over the heads of almost all the states. The responses of the state governments to the fiscal crisis are two-fold. Firstly, they make ad hoc or across the board cuts on public expenditure. To facilitate this process, many states have replaced budgetary control of expenditure with treasury control. Many state governments are also abdicating their financial obligations to their employees, service pensioners and the public. Secondly, state governments resort to borrowings from non-traditional sources at usurious rates of interest. The twin remedies adopted by the state governments only aggravate the ailment. A long term planned response is not yet forthcoming.

Genesis of the Fiscal Crisis and its Dimensions

Though some of the states like Kerala had run into revenue deficits in the seventies itself, such deficits for the states as a whole appeared for the first time in 1984-85. Revenue deficits as a regular and continuous phenomenon appeared in 1987-88. From that year onwards, states started carving out surpluses on the capital account to finance the revenue deficits. In some years, these surpluses were found to be inadequate to meet the revenue deficits leading to overall deficits in the budget.

The dimensions of the fiscal crisis got larger in the nineties when the issue was getting more and more highlighted and the successive Finance Commissions and the Central government were compelling the state governments to implement their version of the fiscal reforms by providing various incentives and disincentives. According to all the indicators currently used[1], the deficits in the state budgets had been increasing in the nineties after falling during the first three years (up to 1993-94). The ratio of Gross Fiscal Deficit (GFD) to Gross Domestic Product (GDP) increased from 3.3 percent in 1990-91 to 4.8 percent in 1999-2000 after falling to 2.4 percent in 1993-94. Net Fiscal Deficit (NFD) to GDP came down from 2.6 percent in 1990-91 to 1.9 percent in 1993-94 only to go up to 4.4 percent in 1999-2000. Gross Primary Deficit (GPD) to GDP ratio increased from 1.8 percent to 2.5 percent between 1991 and 1999-2000 after showing a decline to 0.6 percent in 1993-94. Revenue Deficit (RD) as a proportion of GDP went up from 0.9 percent in 1990-91 to 2.9 percent in 1999-2000, following a decline to 0.4 percent in 1993-94. Overall deficit, however, was low and stood at 0.2 per cent of the GDP in 1999-2000[2].

The ratios given above conceal more than they reveal. In the current system of cash accounting, as against the system of accrual accounting, followed in India, both unpaid bills and receivables are not shown in the budget. As indicated earlier, all the state governments have accumulated huge amounts of unpaid bills. Similarly, the budgets

[1] For definition of these terms, see, State Finances, 2001-02, Reserve Bank of India (RBI).

do not indicate the contingent liabilities of the governments. Faced with budgetary crisis, the governments are forced to reduce their budgetary support to the public sector undertakings (PSU) and cooperatives. Therefore, they have started guaranteeing the loans secured by the latter from the financial institutions. Given the precarious financial position of the PSUs and the cooperatives, the risk to the state governments arising out of the revocation of guarantees is quite high. The aggregate amount of guarantees issued by seventeen major state governments together stood at Rs.123814 crores at the end of March 2000[3]. The value of these guarantees formed 6.4 percent of the GDP. It may be noted that the above ratio is slightly higher than the ratio of states' own tax revenue to GDP in 1999-2000.

The Concept of Fiscal Deficit and its Implications

The term 'fiscal deficit', as pointed out by Gulati (1993) had "hardly ever figured in the lexicon of fiscal policy in India"[4]. But the term has come to be increasingly used from the nineties. The term only indicates the volume of annual borrowings of the governments to finance the combined annual expenditure, on revenue and capital accounts. The higher fiscal deficit is viewed with disfavour because it has the potential to undermine the stability and flexibility of future budgets. But as pointed out by Gulati, the burden of public debt depends upon the direct and indirect returns to the budget from the investments financed by such borrowings. The direct returns to the budgets can be in the form of dividend, interest and non-tax revenue arising from the investments, loans and the capital outlay made by the governments. The returns to the budgets can also be indirect in the form of higher taxes arising from the higher tax potential provided the economy grows as a result of the investments made out of the borrowings. The question whether the fiscal deficit will lead to instability in future budgets depends upon how productively the investments are made and how effective is the government in mobilizing tax and non-tax revenue from the additional income generated from the investments. Ultimately, the apprehensions regarding the growing fiscal deficit arise from the doubts regarding the productivity of public expenditure and the capacity and the willingness of the governments to garner a portion of the additional income generated to the budget. These critical issues are not getting highlighted in the current discussions on fiscal deficits in India, which are preoccupied with numbers.

The apprehensions regarding the growing fiscal deficits and their impact on the sustainability of the budgets or the burden of public debt are not misplaced in India. The net interest payments (gross interest payments minus interest and dividends received) in relation to GDP, had gone up from 1.3 percent in 1990-91 to 2.1 percent in 1999-2000. The ratio of net interest outgo to own tax revenue of states has gone up from 17.1 percent to 27.9 percent during the period. Obviously, as will be seen later, the states have not been able to collect larger tax and non-tax revenues from the incremental GDP either by widening the revenue base or by raising the rates.

The burden of public debt and the sustainability of the budgets depend also on the terms of debt repayments and the cost of debt. There has been a general increase in the cost of borrowings from all sources. The interest rates on

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[2] All the above ratios have been the ones computed by the EPW research foundation. The figures for 1999 – 2000 are of Revised Estimates. See, "Finances of State Governments: A Time Series Presentation", Economic and Political Weekly (EPW) May 19, 2001.

[3] RBI op cited

loans from the Centre hardened as a result of the higher cost of Centre's borrowings from the market, following the financial sector liberalization and the lowering of the Statutory Liquidity Ratio. The weighted average interest rates on states' market borrowings went up from 9.75 percent in 1985-86 to 14 percent in 1995-96. The rate has been coming down slowly since then to reach 9.8 percent in 2001-2002.

Revenue Capital Distinction and its Relevance

In the discussion on fiscal deficits in India, much emphasis is placed on its composition i.e., the uses to which the resultant borrowings are put to. It is pointed out that that the borrowings arising out of fiscal deficit are increasingly used to cover the revenue deficit at the expense of capital outlay (direct capital expenditure of governments and their investments) and net lending. The share of revenue deficit in the fiscal deficit of states increased from 28.3 percent in 1990-91 to 58.8 percent in 1999-2000. The share of capital outlay came down steeply from 49.1 percent to 27.9 percent. The share of net lending by the state governments also came down, from 22.6 percent to 13.3 percent during the above period. The distinction made between the use of borrowings to finance revenue deficits instead of financing capital outlay and for lending is based on the assumption that capital expenditure is more productive than the revenue expenditure. As pointed out by Gulati in 1993, "distinguishing between revenue account and capital account in government spending may not be as helpful as between the purposes for which government spending, be it on revenue or capital account is to be incurred."[5] Contrary to popular impression, not all capital outlays are made on directly productive assets. Even when the capital outlay is made on productive assets, they do not lead very often to growth in the economy or to returns to the budget. In Kerala, it is found that the return on cumulative capital outlay (other than investments) was only 4.6 percent in 1999-2000. Return on irrigation sector which accounted for nearly one-third of the cumulative capital outlay of the state was (–)2.4 percent without taking into account the interest cost. It was found that the return on capital outlay on economic services was no more than two percent. Paradoxically, the return on social services was much higher (7.0 percent). The rate of dividend on outstanding investments was only 0.61 percent. The effective interest rate realized on the state's outstanding loans was only 1.04 percent against the average cost of funds of 10.4 percent. The cost recovery on revenue expenditure of Kerala in 1999-2000 (3.6 percent) was not much lower than the return on capital outlay. In fact, it was higher than the rate of dividend and profits and effective interest.

The implicit assumption that the productivity of revenue expenditure is less than that of capital expenditure is not based on any empirical evidence. There is no evidence to suggest that the productivity of a new capital asset is more than the productivity of revenue expenditure on maintenance of the assets acquired earlier. Similarly, one cannot assert that the long-term productivity to the economy of the expenditure on primary education, which will be largely on revenue account, is lower than the expenditure on an irrigation project, mostly on capital account. The capital revenue composition of expenditure varies according to the sectors in which they are made. For instance, primary education will have larger revenue component than expenditure on higher education or on industry. Many of the

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[4] Gulati I. S. "Tackling the Growing Burden of Public Debt" EPW, May 01, 1993.
[5] Ibid. See also Gulati I S "Reducing the Fiscal Deficit" EPW, July 20, 1991

sectors where the revenue content in expenditure is higher, like health, education, policing etc. are in the State List under the Indian constitution. The sectoral priorities for expenditure by states should vary according to their development status. There cannot be a uniform prescription regarding the proportion of revenue expenditure in the total expenditure without taking into account the sectoral composition of expenditure. The total productivity of public expenditure will be more if the right proportion of revenue and capital expenditure is incurred. The present accounting distinction between revenue and capital does not have much economic logic and can lead to unproductiveness of public expenditure.

Why Fiscal reforms?

Undoubtedly, fiscal reforms are necessary for bringing about macro economic stability. It has, however, to be borne in mind that the role of the States in bringing macro economic stability is limited as compared to that of the Centre. The capacity of the States to monetise its debt is practically nil. Besides, the share of state governments in the combined Internal Debt of the Centre and the states is only 12.2 percent.

The real need for fiscal reforms arises out of the adverse impact of large fiscal deficits, and consequent borrowings, in the context of the present low productivity of government expenditure, on the states' fiscal stability and flexibility. The interest payments as a percentage of revenue receipts have been steadily on the rise. It rose from 13.9 percent in 1990-91 to 21.8 percent in 1999-2000. The share of gross debt servicing in the combined revenue and capital disbursements increased from 14.9 percent to 18.0 percent during this period. The preemption of budgetary resources by contractual obligations like interest payments and repayment of past loans leads to, in the face of looming threat of treasury closure by the RBI, the piling up of the unpaid bills and bouncing of cheques issued by the governments. This has been adversely affecting the credibility of the state governments as also their credit rating. The suppliers of materials and providers of services to the government load the higher interest factor on account of the long delays while submitting tenders to the government leading to higher public expenditure in future. A vicious circle thus gets joined.

The fiscal crisis affects the poor more than the rich. The treasury control operated centrally by the finance department has a bias against the poor, as their access to the powers with discretion is likely to be less. Similarly, in view of the smaller amounts involved, the poor may find that the transaction costs of influencing decisions at the States' capitals are too prohibitive. The unmet financial obligations of a fiscally starved state very often include social security pensions to the old and the disabled, payments under anti-poverty schemes, etc. DA arrears, pensions and retirement benefits of staff and in a few states even staff salaries get postponed. And not all government employees are rich. As seen earlier, debt-servicing obligations because of its contractual nature, has been preempting a good portion of the government resources. Added to these are the other contractual obligations for salaries, rent, pension etc. which may have a first charge on the government's resources. This leaves little for investments, maintenance and provision for current material inputs. This makes public expenditure increasingly unproductive and wasteful. The quality of public services like health, education, policing, administration of justice etc. suffers. This has been the major reason for the commercialization and privatisation of essential public services, making them inaccessible to the poor.

Reasons for Fiscal Crisis

Fiscal crisis became increasingly severe in the nineties when the structural readjustment of the economy was gathering momentum. There is, therefore, a tendency to associate the deepening of the fiscal crisis with the regime of Liberalisation, Privatisation and Globalisation (LPG). Besides, fiscal reforms was one of the key agendas of Structural Readjustment. The relationship between the two, however, has not been unidirectional. Under the LPG regime, the inflation rate has been brought down. This has a positive impact on the public expenditure particularly on the wage and pension bill of the governments. At the same time, the hardening of the interest rates on borrowings of the governments noted earlier had cost the budgets heavily.

The fiscal crisis deepened in the nineties for the obvious reason that the state governments' expenditure increased faster than their revenue. While the ratio of revenue expenditure to GDP increased from 14.2 percent in 1990 -1991 to 15.6 percent in 1999-2000, the ratio of aggregate revenue to GDP came down from 13.2 percent to 12.3 percent. In other words, they were trying to finance an expanding state by higher and higher doses of borrowings, a strategy not sustainable in the long run. The decline in revenue was more on account of the decline in Central transfers (from 5.3 percent of the GDP to 4.6 percent). The ratio of states' own revenue also declined but marginally (from 7.9 percent to 7.8 percent). The total own revenue of the local bodies, which were given wide revenue raising powers and expenditure obligations after the 73rd and 74th Constitutional amendments, also did not show any perceptible improvement. The own revenue of the local bodies in relation to GDP improved only marginally from 0.6 percent in 1990-91 to 0.7 per cent in 1997-98, the latest year for which consolidated data for all local bodies in India are available.[6] If this trend in the resource mobilization by the local bodies continues, it will have important implications to the state budgets. While a number of taxing powers have been taken away from the state governments, they may have to continue to finance local bodies as in the past unless the latter tries to exploit their newly assigned revenue heads.

Expenditure Management

Fiscal reforms must target both expenditure management and resource mobilisation simultaneously. As noted earlier, the state governments had been making ad hoc and across the board cuts in government expenditure, instead of identifying and abandoning unproductive schemes altogether. This has been rendering government expenditure increasingly unproductive in the process. In the present context, a planned expenditure reduction calls for redefining the role of the state governments especially in the context of Indian federal system. In the light of this redefinition, expenditure priorities will have to be determined afresh. This is necessary to strengthen the state's capacity to perform its core functions including its regulatory functions. Under the Indian federal system, the responsibility for social sector expenditure lies mostly with the state governments. And it is in these social sectors that market failures and market imperfections can lead to inadequate allocation of resources and inequitable outcomes. The state certainly will have to play a role in the economic services. But it has to be restricted to such areas where private sector is unlikely to enter.

Some of the budgetary classifications, which are inheritances from the days of central planning of the economy stand in the way of efficient public expenditure management today. We have already noted the implications of one such distinction made, viz, the distinction between revenue and capital expenditure. These classifications prevent, looking at the financial requirements of different schemes in their totality. It is assumed that plan expenditure is more productive and therefore should be immunized as far as possible from all budgetary cuts. For political reasons also, the governments would like to show larger and larger plans, for financing of which, they are prepared to squeeze the non-plan expenditure.

The plan non-plan classifications can be arbitrary and undergo frequent changes and are amenable to sleight of hand by the bureaucrats. According to the current practice, expenditure on new schemes, projects and programmes come under plan. All recurring expenditure including those on earlier plan schemes comes under non-plan. It is not often realized that the non-plan is not synonymous with non-developmental. To quote Gulati again "For that matter, even the distinction between the plan and non-plan spending is not very useful because a good part of non-plan spending is meant for the maintenance and running of the socio-economic infrastructure on which rests the whole edifice of the country's current economic growth."[7] The share of non-plan in the development expenditure in the states was as high as 63.6 percent in 1999-2000. In the case of expenditure on social sectors, which is largely of a recurring nature, the share of non-plan was still higher. The share of developmental expenditure in the total non-plan expenditure was also quite high (48.9 percent). The non-developmental expenditure under the non-plan account includes contractual obligations like interest payments and pensions. For all states, the share of these two obligations increased from 26.8 percent of the total non-plan expenditure in 1990-91 to 32.8 percent in 1999-2000. Bulk of the wage bill, except those relating to the new plan schemes are also paid out of the non-plan account. The continuous squeeze on that portion of non-plan expenditure remaining after meeting the contractual obligations including the salary bill leaves very little for providing current inputs for ongoing schemes and for maintaining capital assets built under the earlier plans. The reasons for the hospitals running without medicines, schools without supplies, dams and canals without maintenance etc. can be traced to this classification and the priority attached to one category of expenditure over the other.

The classification of expenditure into developmental and non-developmental with priority attached to the former category has also led to under funding of those essential services that can be best provided by the governments. As noted earlier, bulk of what is classified as non-developmental expenditure is on account of two contractual obligations viz., interest and pensions, which account for almost a quarter of the revenue expenditure. The other components of non-developmental expenditure include those on such crucial public services like fiscal services,

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[6] Report of the Eleventh Finance Commission, 2000.
[7] Ibid

organs of state, administrative services like policing, judiciary, jails, revenue administration, etc. But these services account for only 13 percent of the total revenue expenditure. In the quest for 'development', the importance of these indispensable services is often underestimated. It is often overlooked that it is the provision of these services by the State which is the basis of the social compact between the people and the State. It is through these services that the state is discharging not only its core functions like policing, administration of justice etc., but also its regulatory functions. The role of these services in providing the most basic infrastructure for development is not often understood. The enforcement of law and order, speedy administration of justice, timely enforcement of contracts etc. are crucial for economic growth in a market driven economy. But unfortunately, the under provisioning of these services has led to low quality and effectiveness of these basic services. This has also led to higher transaction costs for the public. The under funding of these services has led to strange situations where the police are immoblised for want of petrol for their vehicles. We have also got increasing evidence of defacto privatization of policing and judicial functions, in view of the slow moving nature of the ill equipped government machinery. We have the strange phenomenon of the most crucial administrative departments performing the most basic, core government functions remaining the least modernized on account of shortage of funds.

The salary and the pension bills together with contractual obligations like debt servicing leave very little for providing current inputs or for maintenance or for investment. In Kerala, it is found, that these three heads take away more than 70 percent of the revenue expenditure. Salaries and pensions alone account for 54.2 percent of the total revenue expenditure. The question that is increasingly being asked now is: why employ the staff if they do not have work to do or money to spend.

Fiscal reforms is an area where public finance and public administration meet. We cannot have fiscal reforms in India without reengineering the government and implementing budgetary and administrative reforms. As everyone dealing with the government knows, there are a large number of restrictive labour practices in the government. The government machinery is creaking and the systems and procedures are archaic. This has led to the low productivity of staff and the poor quality of public services.

But the present relatively large wage bill should not lead to arbitrary cuts in the wage rates. The reduction must be achieved by administrative and procedural reforms. The wage rates of those government staff, which do not call for any specialized skills are higher than the market rates if we take into account their pension and the retirement benefits. But in monopoly situations in which the government operates and where the staff is endowed with lot of discretionary powers, slashing of wage rates can only add to the growth of corruption. Besides, the present wage rates of government staff requiring specialized skills are lower than the market rates and are not attractive for professionally qualified staff to join the government. As the oft quoted saying of the former Singapore President goes, if you pay your staff peanuts you will get only monkeys.

Mobilisation of Tax Revenue

We had seen earlier how the states had been increasing their expenditure commitments. But the same enthusiasm is not shown by them in mobilizing tax and non-tax resources to finance the expenditure. The tax-GDP ratio increased only marginally during the nineties; from 6.0 percent in 1990-1991 to 6.1 percent in 1999-2000. The increase in the tax revenue of local bodies in relation to GDP was also marginal, from 0.4 percent in 1991 to 0.5 percent in 1997-1998. Part of the reason for the low tax mobilization may lie in the change in composition of GDP. The highest growth in GDP has taken place in the service sectors. Under the Indian Constitution, powers to tax services are largely vested with the Central government. The tax competition among the states in India is also a factor which has prevented larger resource mobilization from the tax heads. Besides, tax administration leaves much to be desired. Even while the states were reeling under fiscal crisis, arrears of tax revenue were mounting.

The states' budgets are also a victim of the poor tax efforts of the Central government in the nineties. Consequently, the share of Central taxes in states' revenue has been coming down during the nineties. The States' share of Central taxes as a proportion of GDP came down from 2.8 percent to 2.6 percent between 1990-91 and 1999-2000. This is largely due to the low tax mobilization efforts of the Central government. The ratio of gross tax revenue of the Central government to GDP declined from 10.1 percent in 1991 to 8.9 percent in 1999-2000. There was also a decline in the ratio of Central government grants to GDP; from 2.5 percent in 1990-91 to 2.0 percent in 1999-2000. The aggregate Central revenue transfers decreased from 5.3 percent to 4.6 percent as noted earlier.

Non-Tax Revenue

The proportion of Non-Tax Revenue (NTR) of the state governments to GDP came down from 1.8 percent to 1.7 percent during the nineties. The proportion of NTR of the local bodies remained stationary at the very low level of 0.2 percent between 1990-91 and 1997-98. The share of states' NTR in their total own revenue had been coming down steeply over the years. From 31.1 percent in 1974-75, it came down to 23.3 percent in 1990-91 and further to 21.9 percent in 1999-2000. The low NTR mobilization is on account of four major reasons. Firstly, the returns from public sector undertakings and cooperatives in the form of interest receipts and dividends and profits are not proportionate to the large volume of loans and investments made available to them by the state governments. In 1999-2000, the share of interest receipts in the total NTR was only 29.2 percent. The share of dividends was just 1.0 percent. The failure of the federal policy to raise rates of royalties on minerals (the major component of receipts under the head 'industries') affected the minerally rich states. National policy on forests affected states like Kerala. Above all, governments of all the states failed to recover a reasonable proportion of revenue expenditure. In 1999-2000, the recovery of costs on public services (excluding heads like state lotteries, industry and minerals and forestry[8]) was only 7.1 percent.

The real reason for the low cost recovery from public services can be traced to the populist politics of the states. The states were dispensing 'welfare' by levying low user charges for public services. Such cheap provision of public services was financed in the past by increasing the tax revenue and by borrowing. The strategy has now become unsustainable because the increasing tax rates are leading to evasion of taxes, trade diversion and growing tax resistance. Limits to borrowing have also been reached by now.

The Issue of hidden Subsidy

In the present discussion, we have avoided the expression 'hidden subsidy', approvingly used in recent years for the less than full recovery of costs by governments and the public sector[9]. The expression is misleading in our view. In non-market, non-competitive situations, the costs need not be the optimum. There is good deal of waste and inefficiency in rendering services by the governments and the public sector, which are sought to be passed on to the users of these services in the name of reducing subsidies. The real beneficiaries of hidden subsidy, therefore, may not always be the users of these services, but the wasteful service providers in the government or in the public sector.

Notwithstanding the above reservation, there is still a case for increasing cost recovery as the rates for public services have not been revised periodically though per capita income and the wage/salary levels had been increasing. Besides, the present policy of low cost recovery treats unequals as equals. The cheaper provision of public services benefits the rich and the poor alike. In fact, in many cases, the poor are not able to avail of many public services as there are many entry barriers for them and they are not able to meet the high transaction costs for availing them. The users of government services may not be unwilling to pay higher rates as they are already incurring high costs to supplement the poor services of the government. One of the prerequisites for increasing the cost recovery is that the quality of public services must improve substantially. Higher cost recovery by the blanket increases in the prices of public services should not be used for passing on to the consumers the costs of inefficiency in the government. Already**,** due to the poor quality of services, large sections of the population which can afford to pay higher rates have opted out of public services in favour of private service providers (e.g. in education, health care). The Private Sector has come to fill the vacuum created by the poor quality of these public services.

Though there is further scope for increasing the non-tax revenue rates, the scope is not unlimited as is often made out by some of the votaries of fiscal reforms in the country. The states are being pushed by them from near total subsidisation to zero subsidisation on the pretext of fiscal crisis. There is a tendency to underplay the externalities of public services and their merit good characteristics. The pendulum appears to be swinging from one extreme position to another. For instance, many governments had been starting, in recent years, a number of 'self financing' professional educational institutions where the entire capital and recurring costs are sought to be recovered from the beneficiaries, identified solely as the students. But such a move leads to total commercialisation of a public service and ignores the externalities of higher education.

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[8] Revenue under these heads have been excluded as they are not representing returns to revenue expenditure.
[9] See, Government of India, Ministry of Finance, Government Subsidies in India, New Delhi, 1997.

Any measure to raise additional resources from non-tax revenue requires fine calibration of pricing, taking into account the merit good character of the public service and on equity considerations. Without such calibration of prices, any move to effect steep increases in the prices of public services can lead to substantial welfare loss.

The Link Between Fiscal reforms and Public Sector Reforms

There seems to be inadequate appreciation about the links between the present fiscal crisis of the states and the inefficiency of their PSUs and cooperatives. The state budgets today are paying a very high price for maintaining their PSUs at the present state of inefficiency. These undertakings are maintained as at present by levying higher and higher taxes or by resorting to costlier borrowings. The major chunk of the loans and investments by the state governments are made to the PSUs and the cooperatives. Because of their poor performance, these organizations do not repay the loans or pay the interest or declare a dividend. In addition to extending loans directly, the State governments had been guaranteeing the loans to these undertakings by the financial institutions. Often, these guarantees are invoked and the governments are compelled to pay, aggravating the budgetary crisis.

Many of the PSUs were started in the past when private capital was not forthcoming. A few others were started in a particular historic context with a specific social or economic objective in mind. But the context in which many of the PSUs were started has changed. These units are maintained today despite their draining the budget partly due to an old mindset equating socialism with public sector and state capitalism. All PSUs are equated with public utilities irrespective of their products and services. The public utilities were not expected to generate surpluses as they were meant to fulfill some larger public purposes, often stated very vaguely. These well meaning notions, however, served only to camouflage the inefficiency and wastage. Besides, PSUs are still useful for dispensing patronage.

Reforms in Budgeting and Control

Any discussion on fiscal reforms will remain incomplete without a discussion of reforms in budgeting and control. At present, the budgets of the states reflect mostly the hopes and good intentions of the governments. They are based on wishful thinking rather than on realistic assumptions. The determination to implement the budgets are not as strong as the zeal for larger budgets drawn very often for political and propaganda reasons. Our study on Kerala state's budget has shown that budgeting efficiency of both revenue receipts and revenue expenditure, as measured by the ratio of accounts data to budget estimates, has been coming down between 1994-95 and 1999-2000.

A perusal of the reports of the CAG on Kerala State finances shows that control on the states' finances by this constitutional body has not been very effective. There is a reluctance or indifference or incapacity on the part of many government departments to furnish crucial information to the CAG. The mistakes pointed out by the CAG are not rectified in time. Year after year, the CAG comes out with their observations, many of them only repetitions. There seems to be either indifference or unwillingness or inability to respond to the CAG's comments. The CAG reports are expected to be examined in depth by the Public Accounts Committee (PAC) and the legislature. The persistence of the CAG's observations indicates that the control over the spending departments by the CAG, PAC and the legislature is increasingly becoming ineffective. The situation in most other states is unlikely to be different from that of Kerala.

Conclusion

Despite the deepening of the fiscal crisis, attempts to bring about fiscal reforms have not been very successful. In fact, the fiscal deficits are only increasing. The real reason for this failure lies in the difficulties of the states in redefining their roles, reordering their priorities and improving the efficiency of the government system and the public sector. Containing fiscal deficits involves hard choices. There is a choice between higher expenditure and larger resource mobilization. There is a choice between higher non-tax resource mobilization and higher taxation. There is a choice between subsidising inefficiencies of the government and the public sector on the one hand and higher taxation. But the states are reluctant to make these hard choices inevitable in fiscal reforms. Instead they choose the softer option of making no choices and allowing in that process the system to drift.